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UNCLAS SECTION 01 OF 03 MEXICO 000529

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STATE FOR A/S SHANNON  
STATE FOR WHA/MEX, WHA/EPSC, EB/IFD/OMA  
STATE FOR EB/ESC MCMANUS AND IZZO  
USDOC FOR 4320/ITA/MAC/WH/ONAFITA/ARUDMAN  
USDOC FOR ITS/TD/ENERGY DIVISION  
TREASURY FOR IA (ALICE FAIBISHENKO)  
DOE FOR INTERNATIONAL AFFAIRS KDEUTSCH AND SLADISLAW  
STATE PASS TO USTR (EISSENSTAT/MELLE)  
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)  
NSC FOR DAN FISK, CYNTHIA PENDLETON

E.O. 12958: N/A

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SUBJECT: KEY MEXICAN LEADERS AND ACADEMICS DISCUSS ECONOMIC  
POLICY

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Summary  
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¶1. (SBU) Two GOM ministers, Bank of Mexico (BOM) Governor Guillermo Ortiz, and leading experts discussed the future of economic policy in Mexico and key economic challenges at seminar hosted by the Autonomous Technological Institute of Mexico (ITAM) on January 11, 2007. Finance Secretary Agustin Carstens said Mexico will probably not have to make any adjustments to the budget this year because of lower oil prices, but noted the importance of fiscal reform to reduce the government's reliance on oil-related revenues. Carstens said that the administration plans to begin negotiations on a fiscal reform soon. He also highlighted the importance of "translating" recent economic growth into poverty alleviation. Ortiz said inflation would remain relatively high during the first half of the year, but then fall during the second half. He said that the recent increase in prices is temporary, but emphasized the importance of these shocks not contaminating inflation expectations. Participants also highlighted the need for pension reform, noting the fast rate at which Mexico's population is aging. Secretary of Communications and Transportation Luis Tellez spoke about the need to address globalization and migration issues and the need for better infrastructure to meet the demands of increasing foreign trade. ITAM professor Jesus Silva Herzog said that the prospects for getting reforms through Congress are better under President Felipe Calderon than they were under the previous administration. He added that Calderon's initial "signals" have been encouraging. End Summary.

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Finance Secretary Calls for Reforms and Poverty Alleviation  
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¶2. (SBU) Speaking at a seminar held at the Autonomous Technological Institute of Mexico (ITAM) on January 11, Finance Secretary Carstens said that the Mexican economy will face a moderate slowdown this year due to slower growth in the U.S. and lower oil prices. He believes Mexico will be able to weather a U.S. economic slowdown through strong

domestic demand, robust consumption, additional investment in the construction sector, and prudent fiscal and monetary policies. Carstens said that if there is a large, sustained drop in oil prices, the government would have to cut spending, but he does not foresee the need to make any adjustments this year. He explained that the government has built mechanisms into the 2007 federal budget to help absorb the shocks associated with volatile oil prices. He said that the recent fall in oil prices highlights the need for Mexico to advance fiscal reform and to confront the challenges facing Pemex.

13. (SBU) Carstens announced that in the coming weeks the administration would begin negotiations with Congress and the states for a comprehensive fiscal reform. He said that measures in the 2007 federal budget -- such as the reduction of the income tax from 29% to 28%, the tax hike on tobacco products, and the scaling back of tax deductions on new cars, assets, and consumption in restaurants -- are "steps in the right direction." According to Carstens, a comprehensive fiscal reform should improve tax collection, cut back on tax exemptions, diversify income sources so the government is less dependent on oil, and address the public pension system. Carstens criticized generous tax deductions and exemptions, which allow companies to significantly reduce the amount of income on which they have to pay taxes. For him, liabilities from the public pension system and long-term infrastructure investment projects called "Pidiregas" represent the largest sources of pressure on public finances.

14. (SBU) Carstens acknowledged that Mexico needs to "translate" recent economic growth into poverty alleviation. To reduce poverty -- a key government objective -- Carstens said that Mexico needs to increase the "capacity" of the

MEXICO 00000529 002 OF 003

individuals, create employment, and invest more in food, health, and educational programs. As a way to help reduce income inequality, Carstens called for better infrastructure in southern Mexico to link this region with the rest of the country. Development banks will help extend credit to small- and medium-sized businesses and to the agricultural sector.

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BOM Governor Discusses Interest Rates and Inflation  
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15. (SBU) Bank of Mexico (BOM) Governor Ortiz sees two main risks to the Mexican economy: the slowdown in the U.S. construction sector and the drop in demand and output of the automobile sector. Ortiz said that in general the economic outlook for Mexico is good, and that inflationary pressures in the U.S. are receding due to the fall of energy prices. Given existing levels of global liquidity, he does not expect other central banks to further tighten monetary policy. Ortiz does not expect 2007 to be a repeat of 2001 in terms of slowed economic growth, citing the growth in housing and consumption credit and the strength of domestic consumption.

16. (SBU) Ortiz blamed the recent hike in tortilla prices on speculation, noting that this pushed up core inflation in late 2006 and early 2007. Ortiz asserted that corn distribution in Mexico is not competitive. The 4.05% inflation seen in 2006 was due to increases in tomato, sugar, and corn prices. He explained that these inflationary shocks were temporary, but emphasized the importance of these shocks not contaminating inflation expectations. He said inflation would remain relatively high during the first half of the year, but then fall during the second half. Ortiz also called for labor, energy, and fiscal reforms.

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Speakers Highlight Need for Pension Reform  
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17. (SBU) Moises Schwartz, the head of the National Retirement

Funds Commission (CONSAR), said that the population in Mexico was aging at a faster rate than many developed countries. By 2030, 17% of the Mexican population will be older adults, and by 2050, the population pyramid will begin to invert. This shift in the age structure will put even more strain on public finances and the pension system. In the mid-1990s, Mexico passed a reform that created individual retirement accounts for private sector employees enrolled in Mexico's main pension system, the Mexican Social Security Institute (IMSS). Schwartz noted that, nevertheless, the Government Workers' Social Security and Pension Institute (ISSSTE), IMSS, the Federal Electricity Commission, Pemex, public universities, and state and local government officials are still under the old defined-benefit plan. More than 3.5 million government employees are still under the old plan. The challenge for the new administration will be passing a reform that balances assets with existing liabilities and creating a National Pensions System. Schwartz said that there is also a need to simplify the system, promote more voluntary contributions, and provide more information on the different funds and on commissions. He said funds need to diversify even more. While they are investing more in long-term bonds, funds continue to invest heavily in government paper.

18. (SBU) Javier Berinstain, Director General of Afore XXI and creator of the 1996 reform, said that future reforms should take into consideration older people who do not have a pension, those who do not have a pension because they work in the informal economy, and those whose pensions are too small to be considered "dignified." He suggested that reforms should move towards a funded capitalization system. Berinstain said reforms were largely a political issue, in which some will lose (e.g. employees of IMSS and Pemex), but the rest of the population will gain. He said it will have to be a joint effort where public sector workers increase

MEXICO 00000529 003 OF 003

their contributions and private sector employees help pay existing liabilities.

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SCT Secretary Talks About Infrastructure and Telephones  
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19. (SBU) Secretary of Communications and Transportation Luis Tellez spoke about the need to address globalization and migration issues and the need for better infrastructure to meet the demands of increasing foreign trade. He said the new administration will face the following challenges: regulating airports to make their fees and services more competitive, improving railway interconnections and regulations, improving the conditions of highways, and using highways and railways to better connect ports to urban production centers.

10. (SBU) Tellez said that along with Cofetel, SCT will look to have more competition and more access to broadband. Tellez said that telephone rates have fallen since 1998, but acknowledged that they were still high.

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Analysts Discuss Calderon's First Steps, Reforms  
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11. (SBU) ITAM professor Jesus Silva Herzog said that the prospects for getting reforms through Congress are better under Calderon than they were under former President Vincente Fox. Silva Herzog said that the "signals" Calderon has sent so far are encouraging, and that they show determination and strength. Since his first day in office, Calderon has shown that he plans to maintain order and lead a cohesive team. Silva Herzog praised the new government's work fighting drug trafficking and organized crime, saying that this was clearly Calderon's top priority. That said, he noted a lack of progress on other fronts (e.g. fiscal and labor reform),

saying that he did not even know what Calderon's second and third priorities were. He believes it would be a good sign if the administration followed through on its plan to begin serious discussions on fiscal reform.

¶12. (SBU) Jorge Chavez Presa -- former advisor to PRI presidential candidate Roberto Madrazo -- called for an energy policy that would increase Mexico's capacity to refine oil, explore and exploit natural gas, and produce petrochemicals. He said that talk of privatization should be changed to talk about "timely supply at lower costs."

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